Target of Monetary Policy

The *federal-funds interest rate* is the *target* of Federal Reserve monetary policy.

From time to time the Federal Reserve changes the target value, and it immediately makes public the new value.

It then carries out monetary policy to hit the target.

Open-Market Operation

An *open-market operation* is a purchase or sale of financial assets by the central bank.

Instrument of Monetary Policy

The primary *instrument* of Federal Reserve monetary policy is open-market operations in Treasury bills and short-term Treasury notes.

Because the stocks of these assets are large and the trading volume is high, the Federal Reserve can buy or sell without upsetting the market and without causing a great fluctuation in the interest rate.

Substitution among Money-Market Assets

Money-market assets (short-term, low-risk debt) are close substitutes, in that investors shift from one asset to another as the relative interest rate changes.

When the Federal Reserve buys Treasury money-market securities, the price rises and the yield to maturity falls. Substitution then causes the interest rate on other money-market assets to fall. In particular, the federal-funds interest rate falls.

Consequently open-market operations in Treasury securities enable the Federal Reserve to hit the target for the federal-funds interest rate.

Long-Term Interest Rate

When the short-term interest rate changes, typically the long-term interest rate changes in the same direction (but by a smaller amount).

Thus the monetary policy will affect the cost of capital and investment.

However long-term debt and short-term debt are not perfect substitutes, so the correlation between the interest rate changes is not perfect—the correlation is high but less than one.

High Employment and Low Inflation

The Federal Reserve chooses its target value for the federal-funds interest rate to achieve high employment and low inflation.